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IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

PSI CORPORATION (f/k/a/ FRIENDLYWAY
CORPORATION, f/k/a BIOFARM, INC.),

Plaintiff,

vs.

ALEXANDER VON WELCZECK,
HENRY LO, MICHAEL DRAPER,
and FRIENDLYWAY AG,

Defendants.

FRIENDLYWAY, INC., KARL
JOHANNSMEIERS, PACIFIC CAPSOURCE,
INC., and DERMA PLUS, INC.,

Nominal Defendants.

Case No. C 07-02869 SBA

**PLAINTIFF'S REPLY MEMORANDUM
OF POINTS AND AUTHORITIES IN
SUPPORT OF ITS MOTION FOR A
TEMPORARY RESTRAINING ORDER**

JURY TRIAL DEMANDED

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1 The oppositions of Defendants Friendlyway AG (“FWAG”), Alexander von Welczeck (“von
2 Welczeck”), and Henry Lo (“Lo”) to Plaintiff’s Motion for Temporary Restraining Order merely
3 confirm that it is warranted and necessary. Both oppositions readily admit that, absent such relief,
4 the shares of stock at issue in this case will be sold to third-parties. Neither opposition sufficiently
5 undermines Plaintiff’s detailed showing of its probability of success on the merits of its claims.

6 Indeed, in their oppositions, Defendants merely snipe at certain parts of Plaintiff’s claims.
7 FWAG asserts the limitations period that applies to Plaintiff’s securities fraud claims, ignoring that
8 longer limitations periods govern myriad claims that entitle Plaintiff to rescind the Share Exchange
9 Agreement (the “SEA”) between the parties, based on Defendants’ fraud. FWAG also attempts to
10 show that it cannot be held liable for the statements of Friendlyway, Inc. (a company it “controlled”)
11 or Lo (its co-conspirator), but it ignores that Plaintiff is entitled to rescission if it was defrauded by
12 *any* of the Defendants. Von Welczeck and Lo do not even make a full-hearted attempt to contest the
13 merits of Plaintiff’s claims.

14 Rather, Defendants’ oppositions concern irrelevant events that occurred years after the events
15 at issue in this case. For instance, FWAG discusses at length Plaintiff’s acquisitions of other
16 businesses, more than a year after it acquired FWI, but it never explains how those facts are relevant
17 to Plaintiff’s claims. FWAG accuses Plaintiff’s current management of causing “devastation” to the
18 company, but it does not explain how those allegations affect Plaintiff’s motion, let alone support
19 those allegations. FWAG refers to an apparent attempt to “cancel” FWAG’s shares, but it does not
20 contend that its shares were actually cancelled.¹ Von Welczeck and Lo discuss “settlement
21 negotiations,” but the document they provide in support shows that those negotiations concerned a
22 *different* dispute between them and Plaintiff, and that their 2004 fraud had yet to be uncovered.
23 Defendants’ focus on events other than the 2004 acquisition at issue is quite telling.

24
25
26 ¹ Under previous management, Plaintiff took the position that certain shares of its stock were
27 canceled. The Form 8-k filing at issue does not specify which shares. In any event, no such
28 cancellation ever took effect, as the company’s subsequent SEC filings show.

1 **I. PLAINTIFF HAS SHOWN A LIKELIHOOD OF SUCCESS ON THE MERITS OR A**
 2 **FAIR CHANCE OF SUCCESS ON THE MERITS.**

3 FWAG's arguments concerning the merits of Plaintiff's claims are flawed. Plaintiff has
 4 indeed shown probable success on the merits. At the very least, Plaintiff has shown a "fair chance of
 5 success on the merits," as required by the second alternative test for temporary injunctive relief. In
 6 fact, while FWAG raises several erroneous arguments concerning Plaintiff's claims against FWAG,
 7 it ignores that Plaintiff is entitled to rescission if Plaintiff was defrauded by *any* of the Defendants.

8 **A. Plaintiff's Securities Fraud Claims Are Not Time-Barred**

9 FWAG argues that Plaintiff's federal and state securities fraud claims are time-barred.
 10 FWAG does not argue, however, that Plaintiff's common law fraud claim is time-barred. Plaintiff
 11 bases its common law fraud claim on the same allegations and evidence as its claims under the
 12 securities laws, and it seeks rescission and restitution as a remedy for both sets of claims. Thus, for
 13 the Court's present purpose—determining whether Plaintiff stands a fair chance of succeeding on
 14 *any* of its claims seeking rescission—the Court need not even consider FWAG's limitations
 15 argument.

16 The Court should also disregard FWAG's timeliness argument because it requires a detailed
 17 fact inquiry inappropriate for this stage of the proceedings. The limitations period for securities
 18 fraud claims begins to run when the plaintiff "discovers" the facts constituting the alleged fraud. 28
 19 U.S.C. § 1658(b). "Inquiry notice" alone, however, does not trigger the limitations period, as
 20 FWAG argues. Rather, the Ninth Circuit applies a "notice-plus-reasonable-diligence standard" and
 21 asks when, *after* inquiry notice, "the investor, in the exercise of reasonable diligence, should have
 22 discovered the facts constituting the alleged fraud." *Betz v. Trainer Wortham & Co., Inc.*, -- F.3d --,
 23 2007 WL 1377613, at *5 (9th Cir. May 11, 2007). These fact-intensive determinations cannot be
 24 made on this record. *See Mosesian v. Peat, Marwick, Mitchell & Co.*, 727 F.2d 873, 879 (9th Cir.
 25 1984) ("The question of what a reasonably prudent investor should have known is particularly suited
 26 to a jury determination.").

Even if the Court considered FWAG's limitations argument, the argument does not withstand scrutiny. For FWAG to prove as it argues that, as a matter of law, Plaintiff had both inquiry notice and sufficient time to discover the relevant facts before June 1, 2005, it faces a considerable burden. "Under the notice-plus-reasonable-diligence standard we apply to securities fraud claims, the defendant bears a considerable burden in demonstrating, at the summary judgment stage, that the plaintiff's claim is time barred." *Betz*, 2007 WL 1377613, at *6. FWAG has not met that burden. FWAG argues that the truth of Defendant's fraud was publicly disclosed in March 2005.² As FWAG also admits, however, Defendants Von Welczeck and Lo *controlled* Plaintiff until May 1, 2006. "[T]he adverse domination doctrine tolls the statute of limitations for a corporation's cause of action against its directors while the directors control the corporation." *Mosesian*, 727 F.2d at 879. Von Welczeck was Plaintiff's CEO, and Lo was its CFO. Between them, Defendants owned 75% of Plaintiff's stock. FWAG, Lo, and von Welczeck also occupied three seats on Plaintiff's board. Plaintiff's original directors only remained on the board with Defendants until June 16, 2005—less than three months after, according to FWAG, the facts of fraud became discoverable. Their replacements were *more* FWAG representatives, including FWAG's own Chief Operating Officer, Andreas Stutz. This gave Defendants majority control of Plaintiff's board of directors.

That Mr. Esrine, disenfranchised by Defendants' fraud, could have brought a derivative suit, is irrelevant to determining whether *Plaintiff* could have brought suit. *RTC v. Fleischer*, 890 F. Supp. 972, 976-79 (D. Kan. 1995) (holding that the limitations period does not begin to run, regardless of shareholder knowledge, until there exists a disinterested majority of nonculpable directors). The possibility of a derivative suit does not affect the application of the adverse domination doctrine. Rather, the question is whether an informed director or shareholder "could have induced *the corporation* to sue." *Int'l R'ways v. United Fruit Co.*, 373 F.2d 408, 414 (2d Cir. 1967); *see id.* at 414015 (determining whether a demand on the board would "have been fruitless").

² FWAG's "public disclosure" argument, even were it meritorious, does not apply to each of Defendants' fraudulent representations and omissions. For example, with respect to FWAG's representation that it did not intend to distribute Plaintiff's stock, FWAG itself argues that Plaintiff discovered the falsity of that representation in April 2006.

1 During most of the time at issue, Plaintiff's board was dominated by Messrs. von Welczeck, Lo,
 2 Trox and Stutz. Plaintiff certainly has raised serious questions as to whether a demand on those
 3 gentlemen to sue themselves would have been fruitless.

4 **B. Plaintiff's Fraud Claims—Against All Defendants—Are Likely To Succeed And**
 5 **Raise Serious Questions.**

6 **1. FWAG's own direct statements were false when made.**

7 FWAG next argues that Plaintiff fails to meet the "merits" element of either of the alternative
 8 tests for injunctive relief, because Plaintiff has not sufficiently shown that FWAG's misstatements
 9 were false when made. This argument, however, ignores the current posture and the purpose of
 10 Plaintiff's motion. Plaintiff seeks temporary injunctive relief to protect its right to rescission. That
 11 right accrues whether Plaintiff was defrauded by all Defendants or just one. For example, if Plaintiff
 12 succeeds only on its claims against Lo, it will be entitled to rescind the entire Share Exchange
 13 Agreement. Thus, temporary injunctive relief is necessary as to all Defendants—even Nominal
 14 Defendants—to prevent the destruction of that remedy. By focusing on whether FWAG committed
 15 fraud, FWAG misses the point.

16 Nevertheless, FWAG *did* commit fraud. To use the example selected by FWAG (and
 17 ignoring FWAG's responsibility for FWI's statements), on December 10, 2004, FWAG (through Mr.
 18 Trox and Mr. Stutz) represented that it was not acquiring Plaintiff's stock for resale. *Less than two*
 19 *months later*, on February 2, 2005, FWAG actually began *closing* agreements to distribute Plaintiff's
 20 stock to other investors. (D.I. 17 (Trox Decl. ¶ 11.)) Plaintiff may prove fraud by circumstantial
 21 evidence; in most cases it is the only evidence available. *Hart v. Browne*, 163 Cal. Rptr. 356, 361
 22 (Cal. App. 1980). That FWAG actually consummated a sophisticated distribution of Plaintiff's stock
 23 just weeks after representing that it would not do so is very strong evidence that its representation
 24 was false.³

25
 26 ³ To make matters worse, FWAG now admits that it used the proceeds of this distribution of
 27 Plaintiff's stock to loan money to Plaintiff, in exchange for *more* stock, at prices well below
 28 market. (FWAG's Br. at 4–5.)

2. **FWAG Is Responsible For Statements Uttered By Others That Were False When Made.**

FWAG's argument that Lo's statements were not false is equally meritless.⁴ Moreover, FWAG ignores that FWI also made statements that were false, for which FWAG is responsible as a "control person" of FWI and as a function of its conspiracy with Defendants. *See infra* Part I.B.3.

Contrary to FWAG's conclusory arguments, there already is ample evidence that these statements were false when made. The following list includes just a few examples.

- On December 10, 2004, FWI, von Welczeck, and Lo certified, in writing, that the financial condition of FWI was consistent with the financial statements delivered to Plaintiff for FWI's year ended 2002, year ended 2003, and half-year ended June 30, 2004. (See Pl.'s Opening Br. at Ex. C §§ 3.5 6.1 and at Ex. F.) Those statements reflected the FWI was solvent and had assets in balance with its liabilities. As is admitted in by the financial statements filed by von Welczeck and Lo *only after* they took control of Plaintiff, which cover the ten-month period that ended over a month *before* December 10, 2004, FWI was insolvent, with liabilities nearly *double* the size of its assets. (*Id.* at Ex. H.)⁵

- On October 6, 2004, after the end of FWI's third quarter, Lo sent to Plaintiff FWI's "Q3 2004 Financial Update." This document stated that, as of September 30, 2004 FWI *already had earned* close to \$2.1 million in revenue, had incurred only \$730,425 in operating expenses, and was profitable. (*Id.* at Ex. B ¶ 25.) Again, however, the financial statements filed by Lo and von Welczeck *after* they gained control show that FWI did not even earn \$2.1 million in revenue by October 31, 2004. (*Id.* at Ex. H.) If FWI did not earn \$2.1 million by October 31, 2004, it certainly

⁴ FWAG also argues that it cannot be held responsible for Lo's statements. (FWAG's Br. at 10–11.) FWAG forgets, however, that Lo made the statements at issue on behalf of FWI. As a "control person" of FWI, FWAG is responsible for FWI's fraud. *See infra* Part I.B.3. Moreover, Lo consistently represented that he spoke for the "FWI team" and for the other selling shareholders. (Pl.'s Opening Br. Ex. B ¶ 11.) FWAG also forgets that it formed a conspiracy with Lo and the other Defendants to use fraud to effect the transaction with Plaintiff. (Compl. ¶¶ 100.)

⁵ Given this drastic difference between what Defendants warranted Plaintiff would receive and what Plaintiff actually received, the Court should reject FWAG's unexplained proclamation that "failure of consideration" is a "clearly insupportable" ground for rescission. (FWAG's Br. at 1.)

1 did not earn \$2.1 million by September 30, 2004, and FWI must have known as much or recklessly
 2 disregarded the truth when it represented that it had. Moreover, those same public financial
 3 statements show that, as of October 31, 2004 (just days after release of this “Financial Update”),
 4 FWI had incurred nearly \$1.2 million in operating expenses and was operating at a significant loss.
 5 (*See id.* at Ex. H.) Unless FWI nearly doubled its year-to-date operating expenses in 25 days, its
 6 October 2004 “Financial Update” was false, and Defendants must have known as much or acted
 7 recklessly.⁶

8 • On December 10, 2004, FWI, FWAG, Lo, and von Welczeck certified and
 9 represented that FWI had not incurred any individual liabilities since June 30, 2004 in excess of
 10 \$25,000, had operated FWI as usual, and had continued to pay its accounts payable. (*Id.* at Ex. C §§
 11 3.6, 6.1, 6.2, 8.1 and at Ex. F.) As of the time Plaintiff acquired FWI, however, Defendants had
 12 caused FWI to incur substantial liabilities that were never disclosed to Plaintiff. For example,
 13 Defendants deliberately concealed the fact that they had not paid for the services of FWI’s own
 14 merger counsel, and they deceitfully delivered FWI to Plaintiff encumbered by that liability. (*See id.*
 15 at Ex. B ¶ 34.)

16 The apparent falsity of these statements has nothing to do with “hindsight.”⁷

17 **3. Plaintiff has produced sufficient evidence to support probable success on**
 18 **its theory that FWAG was a control person of FWI.**

19 FWAG argues that was not a “control person” of FWI, such that it can be held liable for
 20 FWI’s misstatements under Section 20(a). As FWAG concedes, however, determining whether one

21 _____
 22 ⁶ If FWI did double its year-to-date operating expenses in just 25 days, that would constitute a
 23 violation of FWI’s, FWAG’s, Lo’s, and von Welczeck’s written covenant that FWI would be
 operated in the usual course of business prior to the closing. (*Id.* at Ex. C § 8.1.)

24 ⁷ This list does not even include Lo’s and FWI’s many baseless financial projections. Financial
 25 projections, when made without a reasonable basis, constitute factual misstatements. *Provenz v.*
 26 *Miller*, 102 F.3d 1478, 1487 (9th Cir. 1996). For example, on August 30, 2004, Lo and FWI
 27 represented that FWI “was on pace” to earn more than \$1 million in revenue for the third quarter,
 which was already two-thirds complete. (Pl.’s Opening Br. at Ex. B ¶ 24.) As Lo, von
 Welczeck, and FWI would later reveal, FWI only earned approximately \$1 million in revenue
 during the entire second half of 2004. (*See* Ex. H; Ex. I.)

1 is a “control person” is an “intensely factual question.” (FWAG’s Answering Brief at p. 13 (citing
 2 *Howard v. Everex Sys., Inc.*, 228 F.2d 1057, 1065 (9th Cir. 2000).) “Control” may be established by
 3 showing that FWAG had “some indirect means of discipline or influence” over FWI. *First*
 4 *Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 896 (10th Cir. 1992). “A showing of
 5 ‘actual’ or ‘culpable’ participation is not required.” *Id.* at 897; *In re Stat-Tech Securities Litig.*, 905
 6 F. Supp. 1416, 1429 (D. Colo. 1995).

7 Plaintiff’s evidence is hardly “scant.” FWAG owned 100% of FWI until 2002. It retained
 8 30% of the stock after 2002 and was *one of two shareholders* in FWI at the time of the Share
 9 Exchange Agreement. Its CEO was one of three FWI directors. The only other shareholder, and one
 10 of the two other directors, was Defendant von Welczeck, FWAG’s former employee, to whom it had
 11 sold 70% of the company for little consideration. (See Pl.’s Opening Br. at Ex. B ¶ 5.) FWAG
 12 clearly retained influence over von Welczeck—shortly after the closing, von Welczeck transferred
 13 1,529,824 shares of Plaintiff’s stock to FWAG, in satisfaction of “deferred payment obligations”
 14 owed to FWAG. (D.I. 16 – Hlly Decl. at Ex. 6.) At the time of the fraud, FWAG was conducting
 15 “related party transactions” with FWI, including a lucrative licensing arrangement. (See Pl.’s
 16 Opening Br. at Ex. H, note 7 to financial statements.) FWAG even admits that it had so much
 17 influence over FWI that von Welczeck and Lo caused Plaintiff to issue additional stock to FWAG in
 18 2005, at prices well below market. (FWAG’s Br. at 4–5.)⁸

19 A court has held that similar facts actually would be sufficient to *prove* “control person”
 20 liability:

21 For example, WCG and WCG’s officers remained under the “control”
 22 of WMB even after the spin-off due to their interlocking relationships,
 23 the numerous and continuing financial transactions between WMB and
 24 WCG, and the fact that WMB exerted its domination and control over
 WCG as demonstrated by its actions prior to WCG’s bankruptcy.
 Indeed, many of the same officers of WCG prior to the spin-off

25 ⁸ For example, on June 16, 2005, FWAG exchanged \$550,000 in debt for 2,419,384 additional
 26 shares. (D.I. 16 – Holly Decl. at Ex 9.) In other words, FWAG purchased over two million
 27 shares at approximately 23 cents a share, at a time when the market price for Plaintiff’s stock
 was 40 cents per share. (See Ex. A.)

remained as officers of WCG even after the spin-off. Many of these WCG officers had long tenures with WMB Furthermore, prior to the spin-off, many of these WCG officers allegedly owed large debts to WMB

In re Williams Securities Litig., 339 F. Supp. 2d 1206, 1237-38 (N.D. Okla. 2003). Accordingly, under similar facts, Plaintiff certainly has shown a probability of success on this issue.

II. FWAG, VON WELCZECK, AND LO ADMIT THAT PLAINTIFF WILL SUFFER IRREPARABLE HARM WITHOUT TEMPORARY INJUNCTIVE RELIEF, AND THE BALANCE OF HARDSHIPS TIPS IN PLAINTIFF'S FAVOR.

FWAG, von Welczeck, and Lo argue valiantly that Plaintiff's alleged "delay" in seeking injunctive relief reveals that Plaintiff is not faced with immediate and irreparable harm. This argument is nothing more than a red herring. FWAG and von Welczeck readily *admit* that, absent an order maintaining the *status quo pendente elite*, they will take steps to sell, transfer, and encumber the very stock that Plaintiff seeks to recover from them in this action. (See FWAG's Br. at 15-16; von Welczeck & Lo's Br at 6.) FWAG claims an urgent need to distribute its shares, and it has brought a lawsuit to further its effort to do so. Welxzeck concedes that the regularly sells his shares and intends to continue. Indeed, the very fact that FWAG, Lo, and von Welczeck retained counsel on an emergency basis, just to contest an order temporarily preventing them from selling Plaintiff's stock, itself demonstrates the imminent threat. Thus, whether or not Plaintiff delayed in bringing this motion, there is no dispute that, absent temporary injunctive relief, Defendants will take steps that thwart this Court's ability to grant the relief sought by Plaintiff.

FWAG does not contest Plaintiff's showing that this injury would be irreparable. (See Pl.'s Openng Br. at 21.) Von Welczeck and Lo do, but their argument only proves the opposite. Von Welczeck insists that Plaintiff could recover damages from him, in lieu of his stock. (Von Welczeck's and Lo's Br. at 5.) In the same breath, however, he admits that the shares at issue "constitute the vast majority of my net worth." (*Id.* at Von Welczeck Decl. ¶ 7.) Thus, even if damages were an adequate replacement for Plaintiff's shares, Von Welczeck admits that Plaintiff will never be able to recover damages from him. Von Welczeck's and Lo's opposition only further shows the irreparability of the imminent harm faced by Plaintiff.

1 Finally, Plaintiff did not inexcusably delay in bringing this action. The Rule 144 restrictions
 2 on the stock at issue expired at the end of 2006 (these restrictions apparently did not stop FWAG
 3 from distributing the stock to third-parties in February 2005). At that time, Plaintiff's management
 4 was changing hands. The new, current management undertook to investigate the facts concerning
 5 the company's various previous transactions, including the transaction at issue in this case. This
 6 investigation required the retention of forensic accountants, a search and review of reams of
 7 documents, and the locating and interviewing of witnesses. Plaintiff acted as quickly as was
 8 responsibly possible.

9 CONCLUSION

10 For the reasons set forth above, Plaintiff respectfully requests that this Court enter an order
 11 enjoining Defendants Alexander von Welczeck, Henry Lo, Michael Draper, Friendlyway AG, Karl
 12 Johansmeier, Pacific Capsource, Inc. and Derma Plus, Inc. from selling, assigning or transferring,
 13 in any manner, their shares of Plaintiff's stock.

14 Dated: June 8, 2007

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Exhibit A

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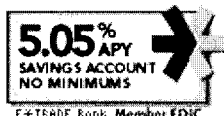
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PRICES

Date	Open	High	Low	Close	Volume	Adj Close*
30-Jun-05	0.35	0.35	0.35	0.35	0	0.35
29-Jun-05	0.40	0.40	0.30	0.35	41,100	0.35
28-Jun-05	0.40	0.40	0.40	0.40	0	0.40
27-Jun-05	0.40	0.40	0.40	0.40	100	0.40
24-Jun-05	0.45	0.45	0.45	0.45	0	0.45
23-Jun-05	0.45	0.45	0.45	0.45	5,000	0.45
22-Jun-05	0.50	0.50	0.50	0.50	0	0.50
21-Jun-05	0.50	0.50	0.50	0.50	5,000	0.50
20-Jun-05	0.40	0.50	0.40	0.50	5,100	0.50
17-Jun-05	0.46	0.50	0.41	0.41	40,000	0.41
16-Jun-05	0.35	0.40	0.35	0.40	6,000	0.40
15-Jun-05	0.30	0.30	0.30	0.30	0	0.30
14-Jun-05	0.33	0.33	0.30	0.30	7,700	0.30
13-Jun-05	0.33	0.33	0.33	0.33	1,700	0.33
10-Jun-05	0.33	0.33	0.33	0.33	4,000	0.33

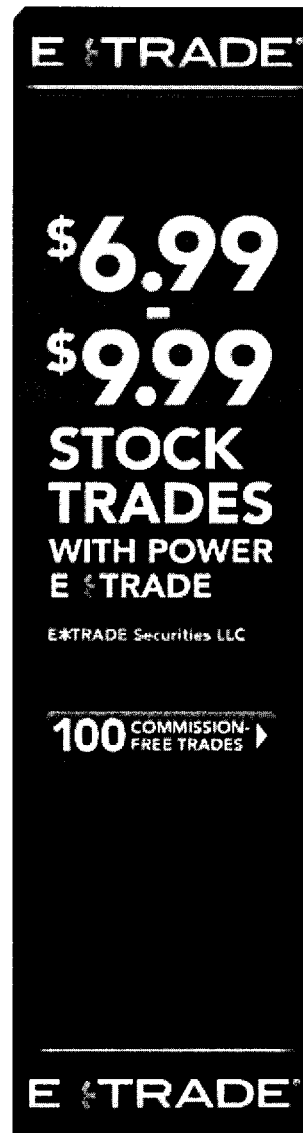
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9-Jun-05	0.33	0.33	0.33	0.33	0	0.33
8-Jun-05	0.33	0.33	0.33	0.33	0	0.33
7-Jun-05	0.33	0.33	0.33	0.33	0	0.33
6-Jun-05	0.33	0.33	0.33	0.33	0	0.33
3-Jun-05	0.33	0.33	0.33	0.33	0	0.33
2-Jun-05	0.33	0.33	0.33	0.33	0	0.33
1-Jun-05	0.33	0.33	0.33	0.33	1,000	0.33

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CERTIFICATE OF SERVICE

I, David A. Felice, do hereby certify that on June 8, 2007, I electronically filed the foregoing with the Clerk of Court using CM/ECF which will send notification of such filing to the following parties of record:

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